JOINT INFORMATIONAL HEARING

SENATE COMMITTEE ON BANKING, COMMERCE AND INTERNATIONAL TRADE
AND
SELECT COMMITTEE ON INTERNATIONAL TRADE POLICY AND STATE LEGISLATION

INTERNATIONAL TRADE AGREEMENTS and the ROLE OF THE STATE

Transcript of Hearing
MAY 16, 2001
STATE CAPITOL, SACRAMENTO
ROOM 3191
9 - 11 A.M.

Senate Committee on Banking, Commerce and International Trade
Mike Machado, Chair
Dick Monteith, Vice Chair
Jim Costa
Maurice Johannessen
Ross Johnson
Betty Karnette
Kevin Murray
Richard Polanco
Jack Scott

Bethany Knorr, Consultant
Trudi Sprague, Consultant

Select Committee on International Trade Policy and State Legislation
Sheila Kuehl, Chair
Debra Bowen
John Burton
Ray Haynes
Maurice Johannessen
Betty Karnette
Michael Machado
Bruce McPherson
Steve Peace
Don Perata
Richard Polanco

Anne Blackshaw, Consultant
Jason Berkman, Assistant

Tuesday, May 15, 2001
FOR IMMEDIATE RELEASE
CONTACT: Anne Blackshaw 916 445 1353

STATE SENATE COMMITTEE TO HOLD HEARINGS ON GLOBAL TRADE AGREEMENTS

On Wednesday, May 16, from 9 to 11 am, in Room 3191 of the State Capitol Building, the Senate Select Committee on International Trade Policy and State Legislation, chaired by State Senator Sheila James Kuehl (D-23), and the Senate Committee on Banking, Commerce and International Trade, chaired by State Senator Mike Machado (D-5), will co-host **a hearing to examine growing concerns about the effect of international trade agreements on the ability of the state of California to enforce its labor, environmental and other laws**.

The hearing will take place in the context of a growing national discussion about the status of state law regulating labor practices and environmental health and safety in the face of international trade agreements that are entered into outside of electoral processes and adjudicated outside of courts. For example, Canadian corporations have utilized NAFTA provisions to challenge California's efforts to halt the contamination of drinking water with the toxic gasoline additive MTBE. The proposed Free Trade Area of the Americas (FTAA) would expand such provisions and invite further opposition to California law.

Officials of the office of the United States Trade Representative were invited to testify at Wednesday's hearings, but declined to do so. Scheduled witnesses include Lon Hatamiya, Secretary of the California Technology, Trade and Commerce Agency; Dave Naftzger of the National Conference of State Legislators; Martin Wagner, of the Earthjustice Environmental Defense Fund; and Dr. Robert Stumberg of the Harrison Institute for Public Law, Georgetown University.

"If California were a country, we'd have the sixth largest economy in the world," says Senator Kuehl. "Obviously, we're a major player in the global economy and, as a commercial center for the Pacific Rim, the last state that would want to choke off trade. Nevertheless, we also have a strong, permanent interest in enforcing the laws we have written that protect the health, safety and prosperity of our workforce and our environmental health as well. We cannot allow agreements that are not subject to public scrutiny or input to undo the will of the voters. We can and we will maintain long-term environmental safety and economic health for our workforce, as well as for investors."

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SENATE COMMITTEE ON BANKING, COMMERCE AND INTERNATIONAL TRADE

AND

SENATE SELECT COMMITTEE ON INTERNATIONAL TRADE POLICY AND STATE LEGISLATION

Joint Hearing:

INTERNATIONAL TRADE AGREEMENTS AND THE ROLE OF THE STATE

Wednesday, May 16, 2001
State Capitol, Room 3191
9 a.m. to 11 a.m.

Agenda

WELCOME & OPENING REMARKS:
Senator Sheila Kuehl, Chair
Select Committee on International Trade Policy and State Legislation
Members of the Select Committee

Senator Mike Machado, Chair
Committee on Banking, Commerce and International Trade
Member of the Committee

PANEL ONE:
OVERVIEW OF FORMATION OF INTERNATIONAL TRADE AGREEMENTS AND HOW INTERNATIONAL TRADE AGREEMENTS INTERSECT WITH STATE LAW

9:10 – 10:00

9:10 Lon Hatamiya, Secretary
California Technology, Trade and Commerce Agency

California and International Trade.

9:25 Dave Naftzger
National Conference of State Legislatures

Overview of how international trade agreements intersect with state law.

9:40 Bob Stumberg
Harrison Institute of Public Law

State Roles in the Global Debate - Oversight, lawmaking and advice to the federal government.

PANEL 2:
NAFTA CHAPTER 11

10:00 – 10:30

10:00 Martin Wagner
Earthjustice Legal Defense Fund

Does Chapter 11 pose a threat to California laws?

PANEL 3:
INTERSECTION BETWEEN CALIFORNIA'S ECONOMIC DEVELOPMENT ASSISTANCE PROGRAMS AND WTO AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

10:30 – 11:00

10:30 Bob Stumberg
Harrison Institute of Public Law

California subsidy laws – Are they illegal under the WTO Agreement on Subsidies and Countervailing Measures (SCM)?

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Background Information

TRADE AND CALIFORNIA California is the 6th largest economy in the world. The 90's has brought unprecedented economic growth to California, and this has been, in large part, due to our success as an export economy. The state's foreign exports have tripled in the last decade to more than $100 billion annually. An estimated 1 in 7 of the state's jobs are directly or indirectly supported by foreign trade, an increase from 1 in 12 a decade ago.

- California has become a world leader in high -value-added industries ranging from electronics to computing, entertainment and environmental and health care technologies. Almost all would agree that state government should actively promote international commerce and investment. Of the 50 states, California has the largest trade and investment program. Five state agencies - Technology, Trade and Commerce, Department of Food and Agriculture, Cal -EPA, Energy Commission, and the Community College System, spend about $13.5 million annually to promote exports, attract foreign investment and operate the state's nine foreign offices. In 1999, California had a $1.2 trillion economy, with over $1.7 billion in exports.

INTERNATIONAL TRADE AGREEMENTS AND THE STATE U.S. trade policy is increasingly encroaching on state responsibilities that previously were unaffected by international trade obligations. As economic global integration increases, trade rules and institutions are expanding their reach, thereby subjecting state measures and practices to scrutiny as well as to economic sanctions.

- **The World Trade Organization (WTO) and the North American Free Trade Agreement (NAFTA) agreements,** as will the Free Trade Area of the Americas (FTAA), bind the states, just as they bind the federal government, subjecting state laws and regulations to the basic trade principles of national treatment and non-discrimination. State measures are thus subject to international trade challenges by any trading partner (including private investors) that believes a state measure violates either of these principles, as well as numerous other technical trade rules. The implementing language of both the WTO and NAFTA require that there be a state consultative process by requiring that the USTR maintain a state point of contact (SPOC) in each state. In California, this point of contact is the Technology, Trade and Commerce Agency.

- **The World Trade Organization (WTO)** was created as part of the Uruguay Round agreements of the General Agreement on Tariffs and Trade (GATT), a multination effort to remove barriers to trade. The contents of this round was approved by Congress in 1994 and went into effect on January 1, 1995 and effected a major shift in the relationship of international law to national and sub-national law. While GATT was voluntary, the WTO agreements contain measures which render them binding and enforceable. If a violation of WTO rules by one member country is suspected, another member country may bring a challenge against it. In practice, member countries often bring challenges at the urging of corporations that operate within their borders; for example, the United States has brought challenges on behalf of the beef industry and Chiquita banana. Challenges will be heard by a three member trade dispute panel. A law found in violation of the WTO rules must be changed, or the country retaining the law will face heavy tariffs. The WTO presently has 140 member countries.

- **NAFTA** is a trade agreement negotiated between Mexico, the United States and Canada. It was approved by Congress in 1993 and went into effect on January 1, 1994. NAFTA is based on a model and philosophy very similar to that underlying the WTO and has a similar dispute resolution system. NAFTA goes a step farther than the WTO in that it empowers corporations to sue governments directly and authorizes corporations to seek monetary damages for loss to their property or profits caused by governmental actions. This is known as Chapter 11. (see below)

- **The Free Trade Area of the Americas (FTAA)** is presently being negotiated and formally kicked off its process at the April Summit of the Americas meeting in Quebec City. The FTAA would extend the NAFTA model to all 34 countries in the Western Hemisphere, with the exception of Cuba.

THE DISPUTE RESOLUTION PROCESS Should a state's measure be faced with an international trade challenge, it is heard by a dispute resolution panel. The design and operation of the WTO's dispute resolution system is established in the Uruguay Round Dispute Resolution Understanding (DSU). The DSU provides only one specific operating rule – that all panel activities and documents are confidential. In comparison, the dispute resolution panel developed under NAFTA allows the complaining party to determine the level of confidentiality. WTO disputes are heard by tribunals composed of three panelists. According to the Western Governors Association, "the consistency of state laws or practices with the governing trade rule would be determined by a panel of international trade experts likely to have little knowledge of

the United States' federal system of government and likely to be biased toward the removal of trade barriers." States would not be allowed to represent themselves, but instead would be represented by the USTR. If a state law is found to be inconsistent with U.S. trade obligations, it would not be automatically preempted by the international ruling. Rather, a state would be urged in consultations with the federal government to voluntarily change its law or enforcement practices to comply with the ruling, or face trade sanctions or a lawsuit by the federal government.

NAFTA CHAPTER 11 NAFTA Chapter 11 accords private parties a right to submit claims for arbitration when they claim harm due to governmental action which results in a future loss of profits, or expropriation. Private companies now have standing to bring claims for economic loss due to a state's implementing its own domestic law. This policy provides corporations unprecedented powers to challenge the authority of sovereign, signatory states. In the past, when private parties doing business with or in foreign states, there were practical and legal limitations on their ability to seek redress. If it was a contract dispute, an investor could pursue judicial or administrative remedies in the courts of the foreign state, or in its own home state. An aggrieved investor could also petition its home government to take up the claim as a state to state dispute before the International Court of Justice (ICJ).

NAFTA's Chapter 11 has essentially created an "open class" of legal equals. Investors can now bring claims against the United States, Canada and Mexico "at will" without first consulting their own governments, and can exert unprecedented control over the adjudication process. Unlike litigants in a judicial system of courts, public documents and governing law, aggrieved investors can now select the arbitrators, the substantive law and the procedural laws governing the arbitration of their dispute, including whether or not they want the proceedings to be confidential. If the ruling finds in favor of the aggrieved party, pressure can be applied to states and localities to change the law, or they could face trade or economic sanctions. Some cases filed under Chapter 11 include:

- **MTBE/Methanex** In 1999 Governor Gray Davis issued an executive order banning the use of MTBE, a gasoline additive that was found to be potentially carcinogenic and was contaminating the California water supply. Methanex Corporation, the Canadian makers of the M (methanol) of MTBE, filed a notice of intent to arbitrate shortly after the executive order was signed and is claiming $970 million in damages, which they describe as "expropriation" of their expected business profits. The case is currently being arbitrated in secret with no access to arbitration documents.

- **Metalclad** A tribunal under NAFTA ruled that Mexico must pay California-based Metalclad Corporation a total of $16.7 million as compensation for the refusal by a Mexican municipality to allow the company to run a hazardous waste dump. This case may have ominous implications for localities seeking to fend off environmentally damaging or discriminatory siting of waste dumps. It is also the first award of "takings"-like damages to a corporation under NAFTA's Chapter 11 provision. Legal scholars predict that this provision may over time result in major takings damages awards, long declined by our domestic legal system.

SUBSIDIES California spends $7.6 billion annually on economic development and job growth programs. We do this through the use of subsidies, tax incentives, grants of goods and services and other economic development programs. Many of these programs are intended to increase

the economic competitiveness of California industries in the trade arena. Tax credits and exemptions accounted for more that $4.1 billion of these 1997 state subsidies.

For example,

- The California Agricultural Export Program (CAEP) provides trade development activities to promote the growth of California's exports of food and agricultural products by creating and expanding global market opportunities.

- The California Wine Commission, Market Development and Research program is intended to increase the sale of California Wine by expanding domestic markets and creating new and larger foreign markets.

- The California Export Finance Office arranges private financing via loan guarantees for California exporters to enhance their export performance of California business.

Under the Subsidies and Countervailing Measures Agreement (SCM) of the WTO, these programs could be considered illegal. The purpose of the SCM is to reduce international barriers to trade in order to provide multinational corporations with improved access to foreign markets. Other countries could challenge California's subsidy laws under the SCM because it obligates the United States to eliminate economic development programs that adversely affect international trade. This runs against the grain of the entire range of economic development, which is to identify, nurture and sustain competitive advantage for one's own country, municipality or state.

The Council for Urban Economic Development, representing national and regional economic development organizations, stated in their policy recommendations to President George Bush regarding subsidies, "Given the substantial impact that trade agreements have on the fortune of communities, state and local governments should have someone to represent their interests on the WTO. Some of the more recent international trade treaties and agreements may conflict with state and local economic development efforts. Many of the newer treaties looking to lower regulatory barriers to free trade are targeting restrictions on foreign investor rights, subsidies, business regulations, permit and licensing practices, and procurement practices as being anti-competitive to global trade.
Common tools economic developers use regularly such as export promotion assistance, living wage requirements and support for women and minority owned businesses could be banned by trade agreements that bar signatory countries from playing favorites."

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CALIFORNIA LAWS AT RISK Working in collaboration with the Senate Select Committee on International Trade Policy and State Legislation, The Harrison Institute of Public Policy has identified over 100 California laws that may be at risk of WTO or NAFTA challenge.

These include:

- food labeling laws including Proposition 65
- laws governing food safety inspection
- laws governing pesticide residue levels
- laws covering air pollution abatement
- laws governing acceptable levels of lead in products
- laws requiring that workers be informed when they are being exposed to toxic materials in the workplace
- laws creating preferences for small and minority owned businesses
- laws creating incentive grants to promote the development of alternative fuel markets
- laws setting limits on the maximum allowable levels of toxins in packaging
- laws setting recycled content requirements
- laws on trade in endangered species
- laws governing waste treatment
- community right to know disclosure laws
- laws governing hazardous materials, emergency planning and insurance requirements
- laws governing medical waste handling, laws governing migratory bird protection

JOINT HEARING:

SENATE COMMITTEE ON BANKING, COMMERCE AND INTERNATIONAL TRADE

SENATOR MIKE MACHADO, CHAIR

AND

SENATE SELECT COMMITTEE ON INTERNATIONAL TRADE POLICY AND STATE LEGISLATION

SENATOR SHEILA KUEHL, CHAIR

INTERNATIONAL TRADE AGREEMENTS AND THE ROLE OF THE STATE

STATE CAPITOL, ROOM 3191
MAY 16, 2001
9:00 – 11:00 A.M.

SENATOR SHEILA KUEHL: This is the first hearing of the Senate Select Committee on International Trade Policy and State Legislation, and we will be joined in just a moment by the Chair of the Senate Committee on Banking, Commerce and International Trade, Senator Machado. This is a joint hearing of these two committees to begin what I hope will be a several-year exploration of the impact of international trade agreements on state legislation -- our ability to create it, our ability to enforce it, whether or not there may be any threats that can stem from these international agreements, to our ability to operate independently as a state.

I thank you all for joining us today because this issue is a timely issue. As the world becomes increasingly integrated, the globalization, as everyone refers to it, it's a cultural integration, it's an economic integration. More and more we are faced with these issues and the intersection of these different laws.

As we will hear this morning from the Secretary of the Technology, Trade and Commerce Agency, Mr. Hatamiya, international trade, of course, plays a crucial role in the State of California and in our economy. We are the sixth largest economy in the world, although I hear seventh. Perhaps you'll clarify that for us. I guess it depends on how much we're worth today.

In the '90s which, of course, are long gone now but had brought an unprecedented economic growth to California, and this has been in large part due to our success as an export economy. Our foreign exports have tripled in the last decade to more than $100 billion annually and an estimated one in seven of our state's jobs are directly or indirectly supported with some aspect of our trade with other nations, which is an increase from one in 12 just ten years ago.

However, as we will hear this morning, there remain many unanswered questions about the consequences of increased trade liberalization on the authority of local and state governments to enact and maintain laws important to their constituencies. The international trade agreements contain provisions that could subject the United States to suit because of state laws. This in turn could bring pressure to bear on the states – Hi, Senator Machado – to avoid putting the United States in this position.

One example, the NAFTA MTBE *Methanex* case in which the Canadian Corporation, Methanex, is suing the United States for $970 million because of California's phase out of MTBE. This is only one stark example of the possibilities.

There are other equally troubling warning signs for state legislators. For example, some of the subsidy laws utilized in California to promote our export industries could be a potential violation of the WTO agreement on subsidies and countervailing measures. This would turn, amazingly

enough, the promotion of California products on its head and open the door to characterizing them as a barrier to trade.

Finally, I also hope we can examine in this hearing and others to follow the lack of transparency in democratic principles in the negotiation and adjudication of these agreements. It's becoming increasingly clear that many of the procedures applicable to the operation of dispute resolution tribunals and other aspects of trade policy formation fail to comply with the most basic, traditional modes of openness and due process.

I want to thank in advance all the witnesses who are here to testify. I'm particularly grateful to Secretary Lon Hatamiya for making the time to attend this hearing. I also want to thank my colleague, Senator Mike Machado, the Chair of the Senate Committee on Banking, Commerce and International Trade who graciously agreed to co-host this meeting this morning. I'm sorry the United States Trade representative and/or any member of his staff were unable to join us this morning for this hearing, but I do hope that this inquiry will serve as a significant step toward developing an oversight and advice role for the California legislature to play.

I'd like to turn it over to my colleague, Senator Machado, for opening remarks.

SENATOR MIKE MACHADO: Thank you, Senator Kuehl. It's a pleasure to co-host this session today.

I share much of what Senator Kuehl has said. I've had the opportunity to serve on a dispute resolution committee with respect to NAFTA at the invitation of USDA in terms of trying to develop protocol to resolve disputes between Canada, Mexico, and the United States. That was an interesting process as they tried to blend three cultures to come together with some sort of consensus, not unlike trying to get a consensus here in the legislature at times.

I think there are some real questions as to how an economy like California, which is one of the sixth largest in the world, that takes on actions that are unique to itself and are pertinent to societal values that we hold in our communities and reflected in the legislature, is how do we incorporate those and make sure that there is consideration given when we engage in trying to determine trade treaties through the national government and what can California do to keep it standing with respect to its own policies. But more important too is how do we make sure that what policies we do have are given due consideration by our federal negotiators as they engage in these various forums to develop trade relationships?

It's important from our standpoint to make sure whether it be or issues surrounding labor and working conditions or issues dealing with vital sanitary standard with respect to agricultural products or issues relating to subsidies and comparative economic advantage that one area may have over another.

An example of the latter is that for our California agriculture to ship a case of processed peaches from California to New York costs more than it does to land a case of Greek peaches into New York. Much of that has resulted because of a subsidy that goes from the processing plant to the grower in Greece where here, the subsidies, even though we may have some export-existent programs, were non-existent domestically to put us on par with some of our foreign competition.

I think this is a good forum to take a look at the issues and for us to realize, that from whatever perspective we may be here today, the issue is broad. It's broad from both social concerns as well as to very pragmatic, economic concerns and all of them blend together as it relates to how we in California reserve our identity as we are a part of nationally-known negotiations with foreign trade.

I look forward to the proceedings.

SENATOR KUEHL: Thank you, Senator.

I'd like to turn first to our California Secretary of Technology, Trade and Commerce Agency. Mr. Hatamiya, welcome. We're very, very, very grateful for your being here and would ask you to make some remarks in terms of an overview in this matter.

SECRETARY LON HATAMIYA: Thank you very much. It's a great pleasure to be here.

Madam Chairwoman and Mr. Chairman, again, thank you for the opportunity to appear before this Joint Committee and really to discuss really an important issue that I know I've had individual discussions with both of you about, and I'm going to touch upon some of the comments that you have made in my informal comments and would be glad to answer any questions regarding the state's role in this issue.

Let me, first of all, begin by outlining our basic goals for international programs, and this is really the mission that's laid forward for my agency and it's really clear and simple.

It's, one, to increase exports of California products into international markets and to increase foreign investment into California. With that said, I use every tool that you give me to ensure that we can maximize that effort, that we try to do it the best way possible and with a very, certainly aggressive staff around the world.

Let me, if I could, just start off my comments by talking about the impact of international trade, to put this in perspective, of why it's so important to California. Our efforts, as I already mentioned, in terms of our goals, are already reflected in positive results. Governor Davis announced in March that California exports surged an incredible 20.7 percent alone in the year 2000 to nearly $130 billion for one year led by a 27.6 percent increase in shipments to Mexico which it set an all-time high of about $19 billion to any one location.

In addition, California remains the number one destination for foreign-direct investment with well over $100 billion invested in our state. This phenomenal growth in international trade has enabled California to become the world's sixth largest economy, Senator. I know that you asked that question, whether it's sixth or seventh, but it's sixth, possibly even larger than that, and over $1.35 trillion in gross state product in the year 2000.

Because of this economic importance, California is poised to play an even more central role in the future development of the global economy for the 21st Century. California exports in 2000 directly and indirectly supported approximately 2.1 million jobs in the Golden State. Since the passage of NAFTA just seven years ago, California exports and NAFTA partners have increased by an amazing 141 percent or $20 billion to a total of $34 billion and created nearly 240,000 new jobs because of the passage of that free trade agreement. Therefore, international trade is a vital element for the continued economic health of California.

California has the most to gain from a positive outcome from a new millenium round of WTO negotiations, the opening of new markets, and the existence of free trade agreements, such as NAFTA and the potential of Free Trade Agreement of the Americas.

Let me just talk briefly about our influence on the trade agreement process. Most pertinent to today's hearing is the fact that California currently plays an important role and can play an even greater role in influencing the trade policy of the United States because we are all cognizant of the fact that entering into international trade agreements is a constitutional responsibility of the federal government.

As a former federal trade official at the U.S. Department of Agriculture, I have spent countless hours, and I will say countless hours, in Geneva, Brussels, Tokyo, and other world capitals negotiating the lowering of tariffs, the reduction of barriers, and the strengthening of

trade adherence mechanisms. These negotiations take days, months, and mostly years to complete with many more years of compliance afterwards.

However, there is an established protocol for California to provide advice, input, in common regarding these ongoing negotiations. If I could, let me just highlight a little bit about our input from the State of California. Not only through our voices of our congressional delegation but also through established advisory committees can California have its input heard. With the passage of NAFTA in 1992 and the Uruguay Round Agreements of 1994 which implements our WTO obligations in the United States, the United States created and expanded, consultative procedures with state and local governments to ensure that states and localities are informed and consulted on an ongoing basis regarding trade-related matters. For day-to-day communications, the U.S. Trade representative created a state single point of contact system.

My agency, the Technology, Trade and Commerce Agency, is a California state single point of contact as designated by the Governor. This system enables us to receive regular information from USTR and comment on federal register notices, and to provide other input as requested.

Since I was appointed as Secretary, I have testified before a USTR hearing in Los Angeles regarding California's priorities for the next WTO round, attended the third WTO ministerial meetings in Seattle, and submitted comments on other priorities for the State of California. In addition, the USTR has established an Inter-Governmental Policy Advisory Committee on trade, or IGPAC, as one of the 33 federal trade advisory committees authorized by the Trade Act of 1974 ranging from agriculture to labor and from defense to the environment, so really those advisory committees cover most industries and, in fact, certainly are important to California.

For example, the Governor is a member of IGPAC and various other Californians serve on the other advisory committees, such as Agricultural Trade Advisory Committees, the President's Advisory Committee on Trade Policy and Negotiations, and the Defense Policy Advisory Committee for Trade, and there are many others. I think that there are Californians that certainly have their input heard.

However, with the change in administration in Washington, there will be obviously changes to these advisory bodies. However, with California industries playing such a vital part in U.S. and international trade, we should continue to be represented, I think, in a very vocal way on those committees. Therefore, I would also suggest that we should better coordinate our input, whether it be through our single point of contact through my agency or a membership on any of these advisory committees. Again, we greatly welcome the opportunity to work with your legislative joint committees to develop and provide more information to our federal policymaking colleagues.

Let me really end my comments by just saying that I welcome the creation and certainly the mere activity of your committees to really assist us in this process. Let me highlight again the goals in my mission are really targeted at increasing opportunities for trade and really not to review trade policy. It is my goal to ensure that we sell more, we open up more markets in the most constructive way. So your assistance can really provide us the input that is requested from USTR.

Let me also put into perspective, USTR is probably the largest federal, one of the smallest federal agencies, much like my agency is the smallest agency in California. So they really, essentially only have two people that are acting as liaison with states and local governments. Although we try to provide as much assistance as possible, it's often overwhelmed by the other priorities that exist at the federal level.

I think it's also important though for us to focus in on how we can work better together. We do receive federal register notices for requesting input. I think it's really a great opportunity for us to work with the legislature and ensure that there are greater inputs to all of these.

I would also suggest that the Californians that are members of these advisory committees can work with this legislative body to ensure that there is a coordinated voice of California as it comes to advising USTR, the federal government. I know that Chairman Machado has mentioned about holding various committee hearings across the state. I would encourage inviting members of those advisory committees to testify to provide input so we can have again a collective and concerted effort for us to really take California to the forefront in the 21st Century for international trade.

Again, it's a pleasure to be here today. I want to thank you for certainly responding to the needs that I have of the May revise before us. I may have to depart to address some of the other committee issues regarding that budget item. So again, thank you very much for allowing me to be here today.

SENATOR KUEHL: Mr. Secretary, thank you. I have a few questions.

The issue of the state's ability to influence the formation of policy and the development of process within the agreements, I wonder if you could comment on the role that we may actually play in terms of the formation of these agreements because my impression is, that though we may have a point of contact about trade, though we may have advisory committees, that when the rubber hits the road and there's negotiations on the actual language of these agreements, that the states have a very small if not non-existent role. Could you comment?

SECRETARY HATAMIYA: I can only comment from my own personal experience, having been a part of that federal system for a

number of years. I would say, that when I was there, and I can only speak from that perspective and I can't speak from the perspective of the administration, but I would hope that we continue really the solicitation of comments from the state. We really attempted to recruit those from important states, such as California. I would also mention that Senator Machado's nomination to the NAFTA Dispute Resolution Committee was done on my behalf and others at USDA, and so I think we do weigh in to try to ensure that there are California perspective provided.

I think we certainly benefit from having Californians in positions of influence in the new administration with California at the head of the Department of Agriculture, the Department of Transportation, and others. I know that there are Californians that are also being mentioned for prominent positions at USTR. I think that enables us to provide that perspective. Again, there are needs for greater transparency in the overall negotiations within the WTO, within the free trade agreements that are being currently considered. I know that they make every attempt, however, to get that input. Again, it's really limited based upon the resources they have available and the resources we have available. So I think we really need to work better together to ensure that that message is brought forward to Washington.

One other aspect, if I could just really end my comments by just saying that, or end my comments to this question, is that we really need to encourage our congressional delegation to play a greater role and have a collective voice when it comes to trade for California. They're the ones that can really weigh in on the impacts of certainly these agreements. Our senators will vote upon those agreements when they come forth to Congress, and our other members of Congress certainly can weigh in as it impacts USTR, the development of policy, so I think it's a very important resource that we need to utilize.

SENATOR KUEHL: Let me welcome our colleague, Senator Monteith, to the hearing.

Senator, did you wish to make any opening remarks?

SENATOR DICK MONTEITH: Just let the games proceed. (Laughter)

SENATOR KUEHL: The games shall proceed.

Senator Machado, did you have any questions of the secretary?

SENATOR MACHADO: Yes. Mr. Secretary, I understand and I appreciate and applaud your role that you've taken to try to expand the trade opportunities, both in terms of business coming into here and the opportunities for California products abroad.

Two questions. In developing the California perspective that you said you've presented in Los Angeles, in the capacity of your office, do you find a way to try to reconcile the issues that are California specific, that they've become at risk or in conflict with national trade policies that been engaged in? Does your department consciously look to try and present those conflicts and to see how California's uniqueness may be addressed?

SECRETARY HATAMIYA: Senator, to answer that very succinctly, no, we don't because really we're looking at focusing how, as I mentioned before, our limited resources at expanding our trade opportunities. I have very little opportunity really to reflect back upon the impacts.

When I testified before the USTR Committee 18 months ago, it was really based upon looking at sectors for negotiation that impacted California, this next round of the WTO. There were services, _____ property rights, agriculture, e-commerce. Those are the things that are very important to California that I highlighted, rather than focusing on potential areas of difficulty. Again, that's where we've concentrated. Again, as I've mentioned in my opening statement, we welcome the opportunity to try to work towards that, but I really don't have the resources to really attempt to do that.

SENATOR MACHADO: I'd like to just change the tone because I'm not looking at it as asking if you do and why you don't. Let's take it to another level.

If we were to do that, is there a value? I think part of the purpose of this joint hearing is to see how we can try to bring something together because it would appear to me, that even within the national advisories committees, we are not represented proportionately to the economic impact that we bring to the table in terms of national trade. So how do we overcome that to talk about some of the things that are unique? Even in agriculture, the representation that we have across the board for some 350 different commodities that are raised in California, the $25 billion, plus the trade that we contribute to that, is not dealt with on the same plain as you're dealing with some of the Midwestern states that are dealing with how do you export wheat and soybeans and corn?

SECRETARY HATAMIYA: I think that's a difficult issue to really address. Both of us come from peach-growing backgrounds. When I was with FAS, I pressed very hard to ensure that peaches were placed at the top of the list when it comes to disputes, in terms of subsidies. USTR chose not to list that. That's one of the challenges that we have before us. You mentioned that in your comments that that's a subsidy that impacts a very critical commodity group in the state. So it is difficult, even in spite of the fact having a Californian there addressing those issues and, again, they're looking at other priorities.

But in the defense of, again, the trade officials, they're looking at what is the greatest bang for their buck that they invest. These dispute resolutions, and I know you're going to get into that in a separate panel, but they take many years to not only submit and achieve but you really need to have a collective voice from a federal government to go forward. They take many years; they take a great deal of resources to move forward, so they take a look at which ones would have the greatest

possibility of being successful. And because there are so few peach-growing entities in countries around the world, those kind of fall off to the wayside.

That's the same thing, and again, looking at many of the programs I know that you're going to be looking at that assist us in expanding trade, the same thing, how high do we want to stick our head up to be considered and to be reviewed? Again, many other countries have similar programs. You know, again, I question their ability to bring forth disputes on some of these programs because, again, they're trying to protect some of the similar programs that they may have. It's really caught up in this whole dispute resolution and really the review process, both at WTO and at NAFTA. So it's a system that I think people are playing against one another to ensure that they can keep some advantage but not damage their own advantage that they might have.

SENATOR MACHADO: Does your office receive complaints where actions taken by this state may be counter to what would be trade parameters that have been established by the federal government other than what we might have, what we hear about in the press?

SECRETARY HATAMIYA: We do periodically but it's not something that's a regular occurrence. Again, our relationship with those in the trade community, again, as you characterize as a positive one, so we're looking at ways to open markets and to create better opportunities. Certainly, we hear about those barriers that may come about but it's more, certain lack of access because of the size of a company rather than because of any certain type of trade barrier that may exist. So we really try to focus in on where we can help people and not where we can't.

SENATOR KUEHL: Mr. Secretary, there may be some division in our concerns, though we're all concerned for the state and the people of the state, but it may be that the legislature may have some greater

concern for the ability to make effective its own laws where the executive may be more focused on the expansion of trade for entities in the state.

If the legislature should want to explore the possibility of our state having some greater influence at the moment of the making of these agreements, given your background both in the federal government and here, could you suggest to the legislature how we might work with the executive branch to attempt to do that in a sense so that we're not legislating on the one hand and giving it away in the federal scene on the other?

SECRETARY HATAMIYA: Well, I think today's hearing is a step forward in that direction. I think we just need to continue to develop forms of communication where we share perspectives, not only from my agency but also from the legislature. Again, I think our best input though comes from members of our congressional delegation. They have the ability to impact and not only the approvement agreements but certainly their approval of budgets when it comes to how USTR and other trade-related agencies are dealing with these issues. So I think that we can, if we come forward with a collective voice, we certainly hopefully can influence those that represent us in Congress in California.

SENATOR KUEHL: Any other questions of the secretary?

I thank you very much. Of course, you're welcome to stay and we may have more collective questions but we also understand any…

SECRETARY HATAMIYA: I welcome that opportunity. I'm looking forward to hear my colleagues here speak.

SENATOR KUEHL: We'd like to turn next to Dave Naftzger from the NCSL, the National Conference of State Legislatures.

Welcome. Thank you very much for joining us today.

If you might take the first two minutes and just give us a little of your background before the rest of your remarks.

MR. DAVE NAFTZGER: Certainly. Thank you very much, Senator Kuehl, Senator Machado, and Members of the Committee for this opportunity for NCSL to be with the committee today. We certainly appreciate the opportunity to visit what NCSL certainly feels is a very important issue and one that's going to be growing in its importance, both to California and to the rest of the state legislatures collectively.

I am the Director for the Agriculture and International Trade Committee for the National Conference of State Legislatures. I provide staff support to a committee of approximately 100 state legislators that are appointed by legislative leaders around the country. We meet approximately three times a year to develop advocacy positions toward the federal government and we do this through a policy process that requires us to have a three-quarters super majority of all of the states represented. So we tend to have a narrow focus on issues related to the integrity of the process that state legislatures have in terms of the communication with the federal government and also in terms of the protection of state sovereignty and state law making.

We historically had a trade philosophy within the organization that is focused on both the benefits of trade to state economies but then on the other hand ensuring that trade investment agreements are compatible with principles of U.S. and constitutional federalism. We have done this through a variety of mechanisms and particularly through communication with Members of Congress and the Administration.

Also expanding on some of the questions that you posed to the Secretary with regards to the IGPAC, the Intergovernmental Governmental Policy Advisory Committee. I serve as the staff liaison for the National Conference of State Legislatures to the committee and provide staff support to the state legislators that serve on that body.

There also has been some recent reforms that you may be aware of that might address some of the questions that you have with regard to

the effectiveness of the IGPAC. There had been some concern from NCSL and state legislators individually about the ineffectiveness of the IGPAC or perhaps its underutilization as a mechanism to receive and put during trade policy negotiations and then also as a means of communication in terms of implementation of existing agreements.

NCSL took the lead in terms of this issue and Representative Paul Mannweiler who was our president a year ago wrote a letter to the U.S. Trade representative asking for some reforms to be made of the IGPAC, including a more formalized institutional role for NCSL and other organizations, the state and local elected officials through an institutional representation rather an individual representation on the IGPAC. The IGPAC members are appointed directly by the Administration. And as you might imagine oftentimes, appointments might be made for political reasons rather than those of substance that might be anticipated from the input into the trade policy process.

It was felt through a more institutionalized representation of NCSL, for example, that the organization would then be able to …(tape switch)… negotiation process for the interest of the states and then also could serve as a fully accountable mechanism to disseminate information to state legislators collectively.

This was done somewhat. There was a consultation with the elected leadership of each one of the heads of the state and local groups, including NCSL and Senator Costa in California who became president of our organization approximately a year ago to recommend members to be appointed to the IGPAC, and the USTR did accept those recommendations and did indeed go forward in officially nominating and making those members of the IGPAC formalized. There also was this staff role that was put in place where NCSL and the other state and local and elected official groups were asked to appoint a staff person to permanently serve as a resource for the members of the committee, so

there had been some incremental steps to improve the IGPAC. It is primarily through my role with NCSL and through the IGPAC that I've been involved with the trade policy process over the past few years.

In terms of the short period of time that I have to visit with you and some of the things that I'd like to cover, economic statistics and some of the figures that the previous speaker identified are often the ones that grab the headlines, but I think you rightly hit on a major issue that's going to become more important and that is the integrity of the state lawmaking process going forward and the impact of international trade and particularly investment agreements, as we've seen through the NAFTA. What are they going to mean in terms of the ability for you in California to make your own laws and have them retained?

I'd like to talk a little bit about the development of the WTO, raise a few brief issues that you may want to consider, and then close with a couple of opportunities where you may be able to gain some more information and some avenues for involvement.

The Uruguay Round is truly the turning point of the role of the states. In 1994 the Uruguay Round was completed. It was a move beyond tariff barriers into areas traditionally in purview of the states – trade and services with the GATS, the agreement on subsidies and countervailing measures which Bob Stumberg is going to mention later in the panel, and also the Government Procurement Agreement which hits right at the core of a very important state function, the ability to procure goods and services on behalf of the state. Perhaps most importantly, the Uruguay Round put in place a strengthened enforcement mechanism. This was an agreement that truly had teeth. As a result, if a member state brings an action against another member state, the losing party must either comply with the ruling and remove the offending measure, provide compensatory trade advantage for the injured

nation, or accept retaliation such as higher tariffs. This is in contrast with the NAFTA that will be expanded on later as well.

Recognized in the potential for disputes involving state law, procedural protections were put in place to ensure the consultation with the states and a vigorous defense of state law. NCSL and other organizations of state and local and elected officials, such as the National Governors Association, were very involved in the negotiations with regards to the Uruguay Round agreements.

Disputes must be brought by national governments against another national government. This again is in contrast to the NAFTA and a point that will be expanded upon later, but it is important to note for this discussion that foreign governments, not private parties or corporations, must bring an action and the U.S. federal government would be charged with defending of state law if that was the underlying subject of the complaint. National governments must take into account political considerations before pursuing a complaint, including fear of retaliation, litigation resources, and other factors that might restrict their willingness to bring a complaint to the WTO.

A very important procedural protection for state law is that the WTO panel rulings are not directly binding on the states as a matter of U.S. law. Regardless of a WTO panel ruling, an adverse decision does not nullify the state law in and of itself under the U.S. domestic law. If the federal government, in the event of an unfavorable decision, would be unable to persuade a state to remove an offending measure, the federal government would then have to bring suit against the state in domestic courts, of course, a private party prohibited from bringing action, and this could be politically challenging, to say the least.

Let me move on briefly to touch on the government procurement agreement and use that to highlight some other important issues that come up in the context of the WTO.

The first issue to note is that the Government Procurement Agreement, the GPA, is a prolateral agreement. Unlike the other agreements, the WTO, it only involves a handful of member states, 26 in the case of the GPA, that have voluntarily agreed to adhere to its strictures. And the idea basically behind the GPA is that members would compete for government contracts on a non-discriminatory basis and that in general purchases would be made based on price and performance rather than design or descriptive characteristics.

As a formal matter, it is only applicable to the federal government's practices and is not binding on the states as a matter of U.S. law. However, 37 states have voluntarily agreed to adhere to this agreement. This adherence was made through a commitment by…

SENATOR KUEHL: You say 37 of the states in the United States?

MR. NAFTZGER: Correct.

SENATOR KUEHL: You're using states both to mean nations and states. If you could clarify as you go along.

MR. NAFTZGER: I apologize for the…

SENATOR KUEHL: No. That's all right.

MR. NAFTZGER: But in the WTO context, they use the term "state" to refer to a national government; and oftentimes, despite my background with the U.S. State Government, it's a switch in thinking that isn't always necessarily easily made.

But as you pointed out, 37 U.S. states are bound to this agreement and this was achieved with one exception, that being Maryland, through a commitment made by the Governor and a letter from the Governor to the U.S. Trade representative. NCSL was critical of the manner in which these binding commitments were achieved and we can expand on that more through the question and answer.

Thus far, there has only been one dispute brought regarding the Government Procurement Agreement over a state law and this was the

Massachusetts Burma law that you may be familiar with. In the interest of time, I won't go into the specifics of that case, except to say that it was a complaint brought by the European Union and Japan over an offending measure in Massachusetts that related to the state's preference to put a pricing penalty of 10 percent essentially on companies that were deemed to be doing business in Burma due to that regime's human rights record.

The point that I would bring forward though, that the Massachusetts Burma case illustrated, is that it highlights that foreign governments may seek to enforce state commitments to the government procurement agreement through the WTO disputes element mechanism. This is a reiteration of something that's always known. It's perhaps the only example where a state measure actually became the subject of an international complaint and really reinforced the seriousness of the commitments that have been undertaken by the federal government and also the states, the 37 states, that have committed to this agreement. It also highlights the importance of state legislators being engaged in this process. As I said, with one exception, the commitment to adhere to the GPA was made by the Governor and the Governor alone without the involvement of state legislators and I think this is troubling to many state legislators around the country. It also highlights the importance for consultation and input mechanisms such as the IGPAC and others so that state legislators do have vehicles to become more involved and informed on these issues.

I'd briefly like to close and just put forward a couple of questions to think about in terms of the discussions going forward on NAFTA-Chapter 11, and some of the other issues that you hear about by the subsequent speakers.

Is the legislature interested in taking proactive steps to adapt and protect state laws from potential challenge? Are there advocacy positions regarding future or existing international agreements that the legislature

would like to advance? And what are the opportunities to participate in the trade policy debate? The state points of contact systems have already been mentioned, as is the IGPAC. But I would certainly encourage you to take advantage of NCSL and any other organizations that you might be a member of to really utilize the institution of NCSL because collectively state legislatures can't have a powerful voice in this debate. And through the IGPAC and other mechanisms, it's very important to make the voice of the state legislatures heard.

With that, I'd just like to thank you again for the opportunity to visit with you today and then welcome any questions.

SENATOR KUEHL: Thank you very much.

Any questions from you, Senator Machado (laughter), because I'll have a few if you don't.

SENATOR MACHADO: Go ahead.

SENATOR KUEHL: I wanted to follow up on the last points that you raised in terms of what legislatures can do. It seems to me that we're a little bit stymied, though I want to praise NCSL for its advocacy in this, in terms of our ability to influence the actual formation of these agreements through any process because, if there's a new agreement, for instance, entered into that expanded the possibility even of investors to sue the United States over a state law, we would not have been able to say we think that's a problem for the states. Or if we did say it, we don't know whether anyone would take it seriously.

Now it maybe, just constitutionally, the structure would forbid any ability for us to really influence this. But what do you think is our strongest ability to influence? You mentioned participation in NCSL. Can you expand sort of briefly on, honestly, whether you think NCSL really can impact or the state legislatures can impact together the formation of these agreements?

MR. NAFTZGER: Well, although I was not with the organization at the time, my understanding from my colleague who was involved with the negotiations is that after the conclusion of the Uruguay Round, that NCSL did have some very meaningful input in terms of the dispute settlement mechanism and the inplementing legislation and the accompanying statement of administrative action does reflect a lot of the protections that NCSL and other groups had sought. I think that in that respect, NCSL was very important. I think that in general there needs to be more involvement by state legislators, and I think that NCSL is a vehicle that is available for you to use but it's only as good as the members make it.

Representative John Dorso, who was the former house majority leader in North Dakota, was an incredibly strong voice on the IGPAC and he's no longer in the Legislature, but I think his participation in that organization really shows the impact one individual can have. One of the criticisms that was raised by NCSL with regards to the IGPAC was that it too frequently consisted of administrative briefings and not enough active participation and dialogue and opportunities for input by state legislators.

Having attended a number of IGPAC meetings, I can tell you that John Dorso did not allow that to take place without standing up and making sure that his voice was heard.

SENATOR KUEHL: But this really sort of depends on who of the individual legislators may be taking an interest in this through NCSL. I understand, that since you are the liaison to state legislators about this, do you find that there is any particular state that is more active than others as a state legislature or is it really sort of individual members through NCSL having the most impact?

MR. NAFTZGER: I would say generally speaking it's those states that are dependent on trade, California, certainly with the existence of

this committee. I think that that's a powerful statement to the importance of trade and trade investment agreements to this state. Most other states, as you know, don't have a similar committee or any structure formally for members to participate in international trade issues.

SENATOR KUEHL: Is there any interest on the part of attorneys general collectively in communicating, or has there been communication between any state legislatures you know of or NCSL with attorneys general who might have to be worried, though the states can't be parties to these adjudications, who might be worried about their ability to protect state legislation?

MR. NAFTZGER: Well, I know that there are attorneys general that sit on the IGPAC. My assumption would be, since NCSL, National Governors Association, National Association of Counties, and other organizations were approached with regards to appointing a staff liaison and making recommendations for individuals to be placed on the committee that they would have been accorded similar treatment, although I'm not certain of that. I do know that there's been also some informal communications but I'm not aware of any formal structure that's been developed by the National Associations of Attorneys General, for example.

SENATOR KUEHL: So is there a regular meeting of any interested state entities concerned with this issue?

MR. NAFTZGER: Well, certainly NCSL, through the committee that I staff, the Agriculture and International Trade Committee, meets three times a year. The other opportunities would be through organizations such as the Council of State Governments, any regional meetings that might involve others, perhaps the National Governors Association or other associations that would provide opportunities for some greater and expanded dialogue. I think that the NCSL organization

is very interested in furthering those opportunities and trying to make them more frequent and close and more meaningful in terms of some of the issues and concerns that I think are increasingly going to be shared among the executive branch and the legislative branch.

SENATOR KUEHL: Thank you very, very much for your testimony.

Move to Professor Stumberg from the Harrison Institute of Public Law.

Welcome. Thank you for coming back and visiting with us again.

PROFESSOR BOB STUMBERG: Good morning, Senator Kuehl, Senator Machado.

Thank you for inviting me. I'd like to focus my remarks on roles that your committee can play, in fact how you can design a role for yourself. My theme throughout is going to be balance, and the balance that I'm referring to is different from the kind of balance you hear people talk about in the trade debate around the country. I'm not talking about struggle for access and power with respect to interest groups, like small business or multi-national companies or like labor groups or environmental advocates. I'm talking about the balance of power of city and state governments within our federal system and how our federal system looks after you overlay a new set of global institutions on top of it. We often talk about our federal system as one of dual sovereignty and increasingly it's becoming one of triple sovereignty where the interactions become much more complex and accountability becomes much more difficult to nail down.

Before I launch into the three points I'd like to make initially, let me just tell you where I want to end up which is to try to encourage your committee by providing you with a menu of concrete ideas or alternatives from which you can choose to get started. Very briefly, it's fundamental stuff. I think the first place to get started is asking questions. Sometimes the most simple things you can do are the most effective.

When the California Legislature asked a question of the U.S. Trade representative, the U.S. Trade representative response – it's a bit like the old E.F. Hutton commercial, that California talks and in Washington they listen. That's not true for many other people around the country. As Secretary Hatamiya explained to you, the USTR is hard pressed. It's a small agency with a crushing mission, I should say a crushing workload, in terms of their mission of promoting America's commercial interests abroad. And when lots of people, including myself or even advocates from other state governments speak up, they're literally too busy to respond in most cases.

When California speaks, the USTR listens and responds, as you've seen. In response to the letter that you, Senator Kuehl, signed in January, along with 11 other state legislators from California, the U.S. Trade representative wrote back a detailed response which, frankly, was unprecedented, not in the sense that USTR is incapable of writing long letters because they have a well-oiled machine to do that, but the letter that you got in response to your questions was legally specific about how the USTR have used the relationship between state law and federal law and the global institutions. It was a fascinating letter which provides the grist for much follow-up in terms of literally more than a dozen questions you can ask and begin a dialogue which will be for the first time public between a leading trading state and the U.S. Trade representative.

Secondly, developing your own capacity is obviously a place to start. Again, I'll refer to what Secretary Hatamiya said. Your capacity begins at home in terms of your own knowledge of these agreements and your working relationship with other parts of state government. Why does not the USTR actively engage with various branches of the states? Because each state has usually not just two branches of government but an elected attorney general and sometimes other elected officers who share power. And the answer again is workload. It's a very complex

federal system and it would be more work than the USTR is now prepared a structure to handle.

While one answer might be to put more demands on USTR, I think it's perhaps more reasonable to look at the states first and say: Do you have your act together? Have you figured out how to talk to your governor or your attorney general in the context of the case you know directly affects California power? What are the rules for sharing information? What's optimal and what is politically feasible? That's what I mean by dealing with your questions of your own capacity.

Thirdly, engaging Congress and other states is obviously crucial. It's important before you criticize the U.S. Trade representative too much about questions on openness or responsiveness to state concerns to remember that that agency has a mission which is to promote American commercial interests. And, yes, they have 33 advisory committees but for the most part, those are structured to provide input on trade promotion for the United States. It's a car without a rearview mirror, if you will. They're looking forward, not backward, in terms of how the United States could be critiqued or challenged in terms of trade law but how the United States can go after other countries.

So it's simply not part of their job descriptions to spend time or to worry too much about state-level concerns. There is an institution whose job that is and that is Congress. It is Congress which has the constitutional responsibility to set rules for international trade. The trade representative implements the authority that is delegated by Congress. Broadly speaking, that meant having pretty much a free hand in the round of tariff reductions and removal of tariff-like barriers to trade. But now that we're into this realm of non-tariff barriers, otherwise known as laws, it's a different world and USTR really was not organized to respond to those kinds of concerns. So in a way, it's almost unfair to expect them to. But it is Congress's job. Of course, the door to Congress

is your own California delegation. A member of your delegation sits on the important subcommittee of the House Ways and Means Committee that has to approve all the trade agreements. And you have many other members that are involved in other crucial committees so you are very well positioned to have influence.

Let me just finish my conclusion before I give you my beginning. Let me just refer you to an experiment conducted by one of your sister legislatures, the legislature or the Province of British Columbia.

Two years ago, the BC legislature was very concerned about a proposed, multi-lateral investment agreement called the MAI, the Multi-Lateral Agreement on Investment. Rather than worry about Canadian Advisory Committees or lobbying the Canadian government, they decided to get their own capacity together first and did it through a process of hearings. When they built that process, people came. Hundreds of people participated. Hundreds of people got educated by the experts that the committee brought in and then participated directly in terms of giving the committee their own ideas in terms of how investment policies should work. It was very much a two-way conversation about how to promote British Colombian Trade interests while at the same time looking in that rear-view mirror to see how their provincial sovereignty might be affected by the agreements.

Hence, two years later, the Canadian federal government has markedly shifted its position on investment agreements and how they should operate, including NAFTA-Chapter 11, as it is now written, and the proposed chapter on investment and the Free Trade Area of the Americas. So here we have a sterling example of how it can be done in terms of a participatory public process which begins at this date of provincial level and which does have a significant impact on federal policy so that's my conclusion.

If you have any questions that you'd like me to respond to directly, please go ahead and ask me right now. Let me tell you what else I might say. (Laughter) You've got my souvenir statement, but the points I want to make are right on the front page.

First of all, in introducing the issue, I want to stress this theme of balance and explain to you why it is or how it might be that the balance of power is shifting away from states.

The first and most simple point I can make is that there are a number of state laws that could be in conflict with trade agreements, simply put. As you know, the staff at my institute at Georgetown Law School has been doing a study of potential conflicts of California law. We looked in about 11 broad areas. We kind of quit looking when we reached 100 examples. We felt that was enough to work with, so now we're looking at those more closely. This is not a definitive study but it does give your committee what could be a blueprint for a menu of what categories of law you might want to pick. You can't look at 100 examples or even 11 categories. You might pick one or two or three and say this is most important to California. We'll start here, the last USTR questions, and then we'll follow up in terms of our own analysis which I think necessarily requires the legislature to talk to the executive branch agencies and those are exactly the motivating spirit behind the bills that you have introduced in this session.

If you look on the first page of my statement, you'll see a few examples that I pulled out for you. I think these are laws that are historically interesting to Californians. Where California has been a legislative leader, as states are famous for being laboratories of democracy, these are your signature areas of state law. I'm curious as to which one or two you might think is most likely to engage a potential trade conflict, if you look at this list.

Is it the headline issues of labor? Is it environmental protection? Actually, if you look at the chart on the second page, you'll see that the area where we found the most examples is economic development. But I don't think that should surprise you. When you think about the number of state laws you have that use purchasing power to advance or promote growth of home-grown businesses within certain categories -- small business, disabled veterans, women-owned business, minority businesses -- it's curious, that while the European Union chose to attack the Massachusetts Burma law, EU had complained regularly in its annual trade barriers report about purchasing preferences at the state level. Never did they mention the Burma law or its predecessor or the anti-apartheid boycott. What did they mention consistently? Small business preferences because they felt that that was a built-in kind of implicit discrimination in favor of home-grown industries, so about half the examples are purchasing preferences.

There are a number of subsidy laws that I will talk about later in the hearing this morning so I won't go into detail now except to point out that it's the combination of economic development policies which California is proud of and I would say aggressively proud of in terms of promoting its own economy and that's how we came to find these examples of potential state-law conflicts with international agreements.

These are the trees. If you step back from the trees and ask yourself what's the forest, I would say again the issue is balance of power. In the case of the European Union's first complaint about a state-purchasing law, the issue there is what is state purchasing power? Our states, as our own Supreme Court has said, entitled to be market participants who may use their purchasing power like any private consumer may which includes the power that you and I have to discriminate between companies based on what country they come from;

if we don't particularly care for a country's, say, human rights or labor policies, you and I can refrain from buying a company's product.

What if we think the company has actually made its product with forced labor or forced child labor? You and I can refrain from buying that product. May the State of California? The question I would suggest, if that's a conflict, were the WTO's procurement agreement. But the point I'm making is not about that law per se but about the fact that this is a primary indicator of state sovereignty, your ability to use your own taxpayers' dollars based on standards of public morality, which you define, or standards of environmental quality which you define or standards of labor or human rights which you define.

Look at the investment cases, just the three that have been filed against the United States. There's a case challenging the Massachusetts law and sovereign immunity. You can't get more of a core of sovereignty interest than the law of sovereign immunity. The case against a Mississippi jury's decision challenges the use of punitive damages to deter corporations from engaging in fraud. A common law, legal remedy exercised at the state level, and that's being challenged as a violation of international law. And, of course, you know your own *Methanex* case, in which a Canadian company, the Methanex Corporation, is challenging California's police power to regulate so as to protect the quality of groundwater and other surface water.

These are core aspects of government power which are difficult if not impossible to challenge in domestic courts. That's why they're international cases, not domestic court cases. They couldn't bring these cases in domestic courts. So it's all about sovereignty in that sense and it's about this shift of power away from states. Now I'm not predicting that the United States is going to lose all these cases. In fact, I don't think anybody in their right mind would try to predict the outcome of these cases. All I'm telling you is that the political players who are in a

position to take advantage of the trade agreements which are now in place are trying to use the agreements to shift power away from states.

Before I leave the power shifting point, let me just add a comment about how the American public feels on this question of balance. It's interesting, that on the one hand, the American public, when surveyed, is predominantly in favor of free trade. The American consumers know a good deal when they see it. We all benefit from lower prices, more competition, and higher quality products. I'll confess that I bought foreign-made cars for a number of years because I felt them to be high-quality and competitively priced. So I benefit just like anyone else does. You can think about what you have in your own kitchen or your own driveway in terms of the benefits of free trade. Perhaps I should more accurately say open international trade for your own pocketbook.

By the way, the percentage of Americans who support the benefits of trade is very high; it's like three-quarters, 74 percent of the public. The same percentage, however, also feels that there should be limits on trade for purposes of protecting environmental quality and upholding what consumers define as international standards of morality when it comes to how workers are treated in their home countries. Seventy-four percent also feel that that should be part of the deal in terms of the benefits as well as the obligations of free trade. And even a higher percentage, 80 percent, believe that the United States should forebear or back off from challenging the European Union when it seeks to limit products which have genetically modified content come into their food supply. As you know, the United States has been on the verge of challenging EU labeling requirements for genetically modified food organisms.

So American people want it both ways and this is built into our very Constitution. It's not schizophrenia; it's balance. People want the benefits of free trade and at the same time they want to see trade,

respect, values of sustainability, environmental quality, and human and labor rights, among other things.

SENATOR KUEHL: Professor, can I ask you a question before you continue, having to do with whether or not there are any aspects of state law, say, for the protection of health, for instance, that are generally acknowledged, can be applied to trade issues and how that interacts? We don't want to import food that might poison us, for instance, or give us diseases. I'm assuming the state can say no to those, but are there any examples of these sorts of…

PROFESSOR STUMBERG: Oh, sure. We found a lot of them.

First of all, even under domestic law, you simply can't say no to a product from another jurisdiction. You have to have a good reason. The traditional test that American courts have used is called the Rational Basis Test. It's simply that you have to create a legislative record that creates a rational basis for limiting someone's access to your market, and you certainly cannot explicitly discriminate against products simply because they come from outside the State of California. That would violate our own Constitution; and when a state explicitly discriminates, according to the Supreme Court, virtually a per se violation of a commerce clause. So that's our starting point.

So how does the WTO change this rational-basis test? It provides a number of rules that relate to food safety, for example, one of which is that the state measure – let's take Proposition 65 as an example. It's one of the more famous California laws. The state measure must be no more trade restrictive than necessary, and a number of decisions under the WTO panels have interpreted that to mean that the state law must be at least trade restrictive.

In addition, in the case of food safety, lawmakers are held to a standard which is that you must have a scientific basis for your law and that there must be a risk assessment which takes into account not only

the risk of doing nothing, as compared to the risk of imposing burdens on trade, but also the economic feasibility of imposing that law and the economic impact on the producer of the product. Put all that together and what it amounts to is a kind of strict scrutiny that the WTO requires, is if you're going to place a burden on trade, in the sense that your law might be more trade restrictive than necessary.

Now we do have a standard of strict scrutiny in American law. However, it's limited to cases where there's a fundamental liberty being impinged upon by state legislation, like free speech or whether state legislation is explicitly or implicitly discriminating against a suspect class like…

SENATOR KUEHL: So did I hear you say that the international trade agreements in essence shift sort of the burden from just a rational basis test to a strict scrutiny test?

PROFESSOR STUMBERG: That's what I said.

SENATOR KUEHL: Okay.

PROFESSOR STUMBERG: Now let's take the example of Proposition 65. Proposition 65 basically says, if I remember it correctly – I'm sure you'll tell me if I don't – that if there's any evidence that a product that a substance, a chemical, poses a risk of cancer or a birth defect, that a manufacturer of a product that uses that chemical must meet the burden of doing the science and putting on the label, a disclosure, of the nature of that risk, before it can be sold in California commerce. What California has done is basically said, if you're trading in a product that poses a risk of cancer or a birth defect, we're shifting the burden to you, the producer, to alert California consumers as to the nature of that risk, as compared with what the WTO requires of government, which is to assure that there's a scientific basis and a risk assessment before government would regulate private commerce.

So I think there's a mismatch or a disconnect there in terms of the way the WTO requires governments or the way the WTO regulates governments and their oversight of the food supply as opposed to the way California has chosen to do this. Informally, through its annual trade barrier reports, the European Union regularly complains about Proposition 65 and a wide array of lesser known California statutes that impose labeling requirements or even bills, for example, that are pending. California could choose to complain about pending labeling requirements on GE, genetically modified foods, like we're complaining about theirs.

So it's all up in the air right now. But I would suggest, if there's at least a debate, that the approach that you've taken to require labeling or set standards for incoming food would be inconsistent with the way the trade agreements look at that, to know for sure, we'll have to wait and see how some of these cases are eventually worked out. But the question before you is, should you simply sit back and watch and see what happens, or should you ask USTR, and perhaps even the European Union, how they feel about your laws, to what extent they believe legally or even practically there are in fact trade barriers there, whether you should be writing your laws differently, or whether your lawmaking process is fine the way it is and we should just do a better job of assuring consumers and citizens that the trade agreements are not going to change the traditional lawmaking authority of the state legislature.

When you wrote that letter to USTR back in January, you asked about precautionary measures, such as Proposition 65, and asked whether or not they are in conflict with the trade agreement. The answer you got back was very interesting. Perhaps it'd be better to have a divinity degree than a law degree in figuring out what it meant. But the way I read the answer was, yes, you may keep making laws like that but they have to be temporary. Precautionary measures may stand under

the WTO, as long as they're provisional. And before they're made permanent, you do the science and you conduct the risk assessment to assure that they're no more trade restrictive than necessary.

I think that's a big change and I'm not saying the sky's falling on your state sovereignty. I am saying, however, it's a shift away from your traditional power.

SENATOR KUEHL: I don't know whether the note that was handed to you, Mr. Secretary, was indicating it's time for you to go, but I wanted to also indicate, that as Professor Stumberg presented, if there's any further thoughts that you had, Mr. Secretary, you, Mr. Naftzger, to add, we want to get as much on the record as possible about the potential impact and certainly appreciate the indication of what states can do.

Mr. Secretary.

SECRETARY HATAMIYA: If I could just add, I'm just fascinated by Professor Stumberg's analysis. I ask him the question, where was he when I was taking the classes in law school? (Laughter) I wish I could have had one of his classes.

I do agree with the analysis that he's laid out in a number of different ways. I think the perspective on the balance of power is an interesting one. But I also would forewarn, certainly this committee, that as we take a look at these various laws that we have in place, how far do we go? Do we open the door for, again, disputes to be taken against these? Again, we review those and we see the effectiveness. But if we review them too closely, then does it open us up for closer scrutiny from other states and other nations? That's the only thing that I would forewarn, is that they're very beneficial to us today and I'd like to maintain those that are effective. Again, I think the reason why there's a balance as well, is that there are other countries that have similar types

of laws that they would like to protect as well, and I think that that's where the balance plays in our favor.

SENATOR KUEHL: Of course, it seems to me with Chapter 11 that every business that finds a potential barrier, it's not like we would be telling them what the laws are so that they can find a barrier. I'm sure they already bumped their nose up against one or another. But speaking of that, NAFTA, a section of NAFTA, I wonder if you would expand for a minute, Professor, on the change that came about, at least in what's proposed for the FTAA (Free Trade Area of the Americas) because of the work and British Columbia. You said that there was a shift in the investor provision or a proposed investor provision.

PROFESSOR STUMBERG: May I say in transition how these two kinds of agreements differ. We're really talking about two animals here – trade agreements and investment agreements.

As Dave told you earlier, neither agreement has an automatic effect on state law. In fact, the U.S. Trade representative, at the time of the Uruguay Round, it was Ambassador Mickey Cantor, and he made it clear to states that they could continue lawmaking in such a way that might violate the trade agreements if they so chose. There's no direct effect. Obviously, such a direct effect would be unconstitutional. Congress can't give away the state's lawmaking authority to an international body. So in the case of both types of agreements, the effect on state law is not direct. The principal leverage is economic. In the case of a trade agreement, if a state law is found to be inconsistent with the trade agreement and the United States loses a trade case, there are trade sanctions which apply, essentially punitive tariffs.

Later, if you want, we can use the *Banana* case that the United States won against the European Union, or perhaps the *Foreign Sales Corporation* case which the United States lost recently, as examples of how punitive tariffs might work. But the important thing for you to know

about punitive tariffs, if the United States were to lose a case involving state law, perhaps another state that has a law like you, for example, you have a law like Massachusetts Sovereign Immunity Law, you have laws like Mississippi court remedies that are being challenged.

If a trade case is lost by the United States, the economic sanction would affect companies in your state and the workers in those companies and the market share of those companies, so there's economic pain which is at work to enforce the trade agreements. That's the principal enforcement mechanism.

SENATOR MACHADO: Are you implying, Professor, that they would be state specific with respect to those sanctions and not national?

PROFESSOR STUMBERG: It depends on the country wanting to bring the action. If another country were to bring an action against California law based on a trade agreement, if they wanted to, they could try to target the sanction based on certain industries to make it as California- centric as possible.

On the other hand, they might think it's better politics to target New York as well and Florida and Texas to make sure that those states feel the pain because of one of your laws which has been found to violate a trade agreement.

SENATOR KUEHL: So they can say "wine" but not "California wine"?

PROFESSOR STUMBERG: No, no. They'd have to say wine of a certain kind and target that on the list. (Laughter)

For example, when the United States won the *Banana* case -- as you know, we're a major banana-producing country. When we won the *Banana* case against the European Union, we created a list of products on which we imposed 100 percent punitive tariffs. That list included English lithographs, German soap. Now it's interesting that I don't think soap has much to do with bananas, but Germany doesn't even have

banana quotas or preferences. The only reason German soap was targeted for punitive tariffs is because Germany is member of the European Union.

So, if you will, a punitive tariff works like a boycott. Essentially, it's a trade boycott as an enforcement tool to enforce the trade agreements. So secondary boycotts are the enforcement mechanism of choice to enforce the trade agreements. That's the way the process works.

I find that irony somewhat interesting because the Massachusetts Burma law was criticized because it was a secondary boycott. So it's okay to have, in fact it's the law, to use secondary boycotts to enforce trade agreements but it's a violation of international rules if the state tries to participate in a secondary boycott to enforce human rights. I say all of that as a digression to illustrate how trade agreements are enforced.

Investment agreements are a different animal. They too use economic leverage but not punitive tariffs. There, the economic leverage is a complaint for monetary compensation, like a commercial arbitration case might see, because the process is modeled after private commercial arbitration. So in the cases against the United States, Canadian corporations have sued the United States of America in an arbitration forum. They are seeking in the first three cases $1.7 billion in compensation from the United States. So it's not the State of California which is sued, so to speak, in either a trade case or an investment case. It's the United States of America and the investment cases involved essentially request for compensation as the economic leverage, which is all designed to promote compliance. It's not a matter of money, from the perspective of the trade agreements. It's really a matter of creating enough economic pressure to bring companies into compliance with the agreement.

Now, your question.

SENATOR KUEHL: Professor, first of all I wanted to welcome Senator Costa who was mentioned earlier in his role as President of NCSL, and we had wonderful testimony from Mr. Naftzger. We had almost concluded our first panel, but I think that some of the speakers at least will be able to stay until 11 o'clock.

I wanted to, however, indicate to you, Professor, since we're going to come back to you to talk a little bit about the subsidies piece, and I want to make certain that Mr. Wagner gets his ability to give his testimony, if you could conclude perhaps on this part of your testimony and then we can move into a little bit more of an explanation of the impact of Chapter 11 and then come back to visit the subsidies issue.

PROFESSOR STUMBERG: Let me just conclude by saying, that in response to all of this, I'll ask you what roles can you play. I think there are three plain, old-fashioned traditional roles that legislatures always play, and they're just as appropriate for trade as they are anything else. Those roles are: Oversight, lawmaking, and advising the federal government, otherwise known as lobbying Congress.

The oversight role simply means, are you aware of the potential impact the trade agreements could have on the state lawmaking process? If not, you want to drive without your rearview mirror. If you are aware of what that impact is likely to be, how would you go about figuring out the potential for conflict or whether it's worth worrying about? How would you know if you believe that there is a potential impact, that the rules are changing, and you would like to do something about that, either communicate to the federal government, or to change your own lawmaking process?

With respect to lawmaking, there are obviously some areas of lawmaking that are more trade sensitive than others. Subsidies now is trade sensitive. Regulating commerce and foreign food is clearly trade sensitive. Trying to ban invasive species, critters that attach themselves

to ships and other forms of commerce, is very trade sensitive. Purchasing preference is hyper-trade sensitive. Any law that reflects on labor or human rights is hyper-hyper-trade sensitive.

So now that you know that those areas are trade sensitive, are you going to make your laws any differently? You can read these trade agreements, if you will, as a series of strong hints, but perhaps you can bring your lawmaking up to date, so to speak, and to make it a 21st Century lawmaking process rather than a 19th Century lawmaking process which most states actually have.

Finally, and I would recommend, by the way, considering that this is also the Banking Committee, that if you have one area that's really worth a look for the benefit of your citizens, it's subsidy reform. There is much that is wrong about the way states spend their money to promote their own commerce. There's much abuse; there is a tremendous amount of waste. Frankly, I would think that the lack of taxpayer accountability, in terms of state economic development subsidies, much of which are tax breaks which are not visible to the public, that's the issue that ought to be the issue on the front burner and not this concern about whether trade agreements are encroaching upon your export promotions. It's the fact that California taxpayers are not getting their bang for their buck in terms of these development subsidies.

SENATOR MACHADO: I was just going to make a comment. I question where the political pressure is the worst, from the constituency that's the benefactor or from the nations that feel that they're being discriminated against because of those?

PROFESSOR STUMBERG: Well, my observation, in terms of domestically, is the former, absolutely. It's the war between the states. NCSL, to its credit, has tried to work on this for years, so has the National Governors Association, but the competition is so intense. The

competition for capital among states is so intense, that it attempts to make for a meaningful subsidy reform, if not to date has been successful.

I think the chemistry of having this WTO agreement, now looking over our shoulders, so to speak, is positive, that it will be a way for states to take seriously their job of working together to reform subsidies on a multi-state basis, working through NCSL and NGA and other multi-state organizations. California was a leader in creating a multi-state tax commission which revolutionized the efficiency and fairness of collecting taxes from multi-national companies. I think you can do the same in terms of subsidy reform.

SENATOR KUEHL: Senator Costa has a question, and the Secretary indicated to us that he had to leave.

SECRETARY HATAMIYA: It's not because of the arrival of Senator Costa, by the way. (Laughter)

SENATOR JIM COSTA: I'm a little suspicious, Mr. Secretary. I'll ask you the first question then.

SECRETARY HATAMIYA: Yes, sir.

SENATOR COSTA: Since you have to leave.

This is indirectly related to the subject matter at hand. But last year, you indicated to a couple of different policy committees that you were in the process of undertaking a review, a systematic review, of the overseas offices at California finances to promote trade and commerce. I know that there's been some sort of an update on the report. But I guess I'd like to know where that currently is and we can discuss it at a later date but whether or not the findings that you determined are developing in some sort of an action plan to make changes.

SECRETARY HATAMIYA: Absolutely. We had an oversight hearing back in March with Chairman Machado's committee.

SENATOR COSTA: Unfortunately, I wasn't able to be there.

SECRETARY HATAMIYA: I'll be glad to provide some of the update that we provided then. We have just recently released a yearly report for those offices that I'll provide to you as well and it'd probably be more beneficial for us to have –

SENATOR COSTA: Separate conversations?

SECRETARY HATAMIYA: -- separate conversations on some of the other issues.

SENATOR COSTA: Okay. I'd like to do that.

SENATOR KUEHL: Thank you, Mr. Secretary.

SECRETARY HATAMIYA: Madam Chairman, thank you very much for the opportunity to be here today and, Professor, other colleagues, I appreciate the comments. It was very fascinating to hear.

SENATOR KUEHL: Thank you for being here. I very much appreciate it.

Go ahead, Senator.

SENATOR COSTA: Lon, let's set up a meeting with regards to that.

SECRETARY HATAMIYA: I'd be pleased to.

SENATOR COSTA: Okay. Thank you.

SECRETARY HATAMIYA: Thank you.

SENATOR COSTA: To the last witness, Professor, I think all of us were interested in your last statement. The trouble is, that as you know, states still compete against one another for commerce and oftentimes I think also to their disadvantage. A lot of our legislative efforts to provide assistance to various industries have been a threat that we are going to somehow lose various industries because they're going to neighboring states, and there's all sorts of anecdotal stories that we can go back on.

What you're saying is that you think the WTO forces states in a way that we have been unable in the past to come together because, out of the growing global marketplace that we're not going to be able to

continue to get played off on one another by some of these various industries?

PROFESSOR STUMBERG: Not exactly, Senator Costa. "Force" is too strong a term. In fact, the WTO agreement only prohibits export promotion subsidies. If you have a subsidy program which companies are able to, shall we say, get states to compete with each other to cough up some money to relocate a plant or a branch facility, and if that subsidy program is not really going to have an international trade impact, there's nothing in the WTO agreement that would make that a problem under the international rules. In other words, if your subsidy is ineffective, there's no problem under the WTO. If your subsidy is effective under the WTO to the point that it affects international trade, then it's an international trade problem.

All I'm suggesting is that the combination of the WTO's one clear trade rule about the impact on international trade from subsidies, coupled with its fairly stringent requirements for disclosure of subsidies, adds fuel to the fire. It adds momentum, if you will, to the need for a state-level reform of the subsidy process. I think it's one more important piece of encouragement for the states to work together on a multi-state basis, perhaps a multi-state, multi-provincial basis.

SENATOR COSTA: We're attempting to work on a multi-state basis, as you may know, right now on the issue of e-commerce, to try to provide simplification in the way that nexus is established between the 45 states that have a form of the sales and use tax in local government and we've developed model legislation. We don't have obviously all of the states in line at this point, but it's kind of a process you have to work through.

Do you think those kinds of efforts have the potential to expand upon trying to create a more level playing field?

PROFESSOR STUMBERG: Absolutely. I think without it, without a multi-state process and without NCSL and NGA being part of the team, I can't imagine how subsidy reform could be successful. It's not that – this has been tried. If it were to easy to fix, it would have been solved decades ago.

SENATOR COSTA: That's what I say about our water problems.

PROFESSOR STUMBERG: But on the other hand, as a policy analyst, just looking at the picture, I can tell you there are some obvious pieces missing. For example…

SENATOR COSTA: Such as.

PROFESSOR STUMBERG: Congress does not have a role to play.

SENATOR COSTA: They're playing a role right now in e-commerce.

PROFESSOR STUMBERG: I understand and that's why it's moving somewhere. Part of the role actually has been adverse from the point of view of the states.

SENATOR COSTA: Correct.

PROFESSOR STUMBERG: But Congress is a player and that's making the ball move forward. When it comes to subsidy reform, in some ways…

SENATOR COSTA: The threat of their pre-emption, obviously, is an encouragement.

PROFESSOR STUMBERG: Right. The Congress cannot pre-empt the way the states spend their own subsidies, except perhaps, through international trade agreements.

SENATOR KUEHL: Can I interrupt for just a second. I wanted to sort of lay more of a foundation in testimony about the subsidy issue. We've sort of jumped into talking about it without doing that. So if it's okay with you, Senator…

SENATOR COSTA: I'll hold that.

SENATOR KUEHL: I wanted come to that at the end of our discussion. The witnesses are welcome to…

SENATOR COSTA: Let me ask one question of Mr. Naftzger, only because it relates to, I think, to his testimony.

SENATOR KUEHL: Okay. Of course, and ask Mr. Wagner to come forward and make certain that we get his statement on the record.

Go ahead, Senator.

SENATOR COSTA: David, based upon the questions that have been asked by both chairs of these two committees and we appreciate your being here, obviously, what types of efforts do you think we can move forward on with the sponsorship of the National Conference of State Legislatures that would help try to tie, to get the sort of multi-state participation in terms of moving on from here? I don't know if you provided that in your testimony or not in terms of where you might take the work product of this hearing and build on it, either at our subsequent meeting in San Antonio where we have our annual meeting or later on as part of our, I guess it'd be an assembly on federal issues, a policy committee?

MR. NAFTZGER: We discussed briefly some of the opportunities within NCSL, through the Agriculture and International Trade Committee, and also through the ability to relate to the Intergovernmental Policy Advisory Committee as a means for the committee to use NCSL to put forward some advocacy positions.

I think that some of the big issues that are on the horizon, the Free Trade Area of the Americas and a lot of big trade issues, in terms of reform of the WTO that may be forthcoming or revisiting some of the provisions of the NAFTA, there's some very big issues, and any input that we can receive from Members of the California Legislature can only strengthen the voice with which NCSL speaks.

SENATOR COSTA: Let's talk with the two chairmen after this hearing to determine how we might try to take advantage of those opportunities, both in San Antonio and after that to build on this.

SENATOR KUEHL: I'd welcome that. We invited Mr. Naftzger particularly because are looking to that kind of relationship and the work of all the states together and others that might be active.

Let me welcome Martin Wagner, if I may.

SENATOR COSTA: He's part of your staff in Washington.

SENATOR KUEHL: He actually offered himself even before you did (laughter) so we're very happy about that.

Mr. Wagner, welcome. We wanted some testimony from you about the Chapter 11 problem, at least I think that's how Earthjustice sees it. Anything that you might want to comment, if you're familiar with any proposals and the changes in the investor provision that may be helpful, that may be more worrisome for the state, whatever.

Welcome.

MR. MARTIN WAGNER: Thank you very much. Thank you, Senators Kuehl and Machado and Costa. It's a pleasure to be here this morning.

My name is Martin Wagner. I direct the International Program for Earthjustice Legal Defense Fund, and I'm also an adjunct Professor of International Trade and Environmental Law at Golden Gate University School of Law.

I appreciate the opportunity to discuss this morning the impact of international investment agreements on the ability of California to protect and promote the important interests of its citizens.

Several years ago, the City of Santa Monica had to shut down half of its municipal drinking water wells because they were contaminated with a chemical called MTBE. The government of California's response to this public health threat, which many of you are probably aware of, is

one piece of a story that demonstrates the threat to Californians posed by international investment agreements. I'd like to tell that story briefly to put these issues into context.

MTBE is a chemical used in nearly all gasolines sold in California. In recent years, it's become clear that MTBE is also a threat to the environment and human health. The primary harm imposed by MTBE is contamination of ground and surface water. Because MTBE does not absorb into soil, when it comes into contact with water, because of a gasoline spill, for example, a leak from a boat or other engine or a leak in a storage tank, MTBE spreads quickly. Once it enters the ground or surface water, it's difficult to detect, resist, decay, and is hard and very costly to remove. The University of California study estimated that at least 10,000 sites in California have been impacted by MTBE contamination.

MTBE makes water unfit for human consumption. Concentrations in even the low-parts-per-billion range can cause water to smell and taste like turpentine, making it completely undrinkable and it doesn't take much gasoline to contaminate a lot of water. For example, ten gallons of gasoline, which could easily leak from the tank of a single car in an accident, contains enough MTBE to contaminate millions of liters of water. A single accident in Maine, in fact, led to the contamination of over 20 domestic wells.

MTBE also has other effects on human health. It's known to cause cancer in mammals, as well as neurological, respiratory, and skins problems in human beings. Human exposure can occur not only through drinking contaminated water but through inhaling water vapor in the shower, for example, or while cooking. Once in the blood stream, MTBE goes to the kidneys, brains, and liver where it is metabolized into formaldehyde which is known to be a probable human carcinogen.

Because of the threat posed by MTBE, the California Senate and Assembly passed the MTBE Public Health and Environmental Protection Act in September 1997. The law called for the University of California to evaluate the human health and environmental risks of the use of MTBE in gasoline and for the Governor to take appropriate action in response to the findings. The study confirmed the risks I have just described, concluding that the use of MTBE in gasoline in California poses a "significant risk to the environment." As a result, in 1999, the Governor ordered MTBE to be removed from gasoline by the end of 2002.

This is where international investment rules come into play. Three months after the Governor announced the MTBE ban, a Canadian corporation called Methanex, which manufactures one component of MTBE, filed a claim against the United States in an obscure international forum demanding $970 million if California insisted on following through with the MTBE ban.

For someone not familiar with recent trends in international investment agreements, this may seem like a ludicrous proposition. It might even seem like extortion. The maker of a harmful chemical demands nearly $1 billion in exchange for a measure to remove that harmful chemical from public consumption.

Under the North American Free Trade Agreement, however, and other international agreements the United States is negotiating, the claim is not so easily dismissed. NAFTA includes a section called Chapter 11 devoted to protecting foreign investors. It is these provisions on which Methanex relied in bringing its claim against the United States. And let me describe just a few of the threats that these provisions pose to the ability of California to protect its environment, its citizens' health, and other citizen interests.

The first issue has to do with NAFTA's protection against what is called "expropriation". The concept of expropriation is international law's

version of what U.S. law calls "takings". The principle is very straightforward. The government can take your property for the benefit of society at large as when it decides it needs to build a highway in certain areas of private property, but it must pay fair compensation for the property it takes.

In the United States, however, we've limited the rule because we recognize that our governments could not carry out their responsibility to promote the common good if they had to pay every time government action has any impact on private property. In a nutshell, the U.S. rule is that government must pay if it takes your property outright, but it does not have to pay for a reduction in property value if a government measure reduces the value of many people's property but doesn't remove the property entirely.

The U.S. Supreme Court put it well when it said that the impact of regulations protecting important public interests "are the burdens we must all bear in exchange for the advantage of living and doing business in a civilized community."

NAFTA's investment chapter, however, has thrown this finely balanced system out of kilter. Chapter 11 provides the governments must compensate foreign investors for expropriation as well as measures that NAFTA calls "tantamount to expropriation." It was on the basis of this provision that Methanex based its nearly $1 billion claim against the United States. It argued that the California MTBE ban, while not actually taking away Methanex's property, was tantamount to expropriation. Under Methanex's theory, California should either remove its ban or compensate Methanex for the profits the company might have earned from future sales of this chemical that the state has determined to be harmful to human health and the environment.

Let me note here one difference between investment agreements and the WTO agreements that were discussed earlier. Methanex made

the decision on its own to bring this challenge. It didn't need to go to the government to a binding international arbitration proceeding. And Methanex's claim was not without precedence under NAFTA. A U.S. corporation challenged Canada over a similar ban on a potentially carcinogenic gasoline additive. Rather than litigate the claim, Canada removed the ban and paid the company $13 million.

In Mexico, a state government refused to permit a U.S. corporation to operate a hazardous waste facility where it could contaminate groundwater and harm a sensitive eco-system. The NAFTA arbitration tribunal decided that Mexico had to pay the company $90 million in compensation.

It's easy to see how this NAFTA expropriation provision is turning the U.S. system I described earlier on its head and impairing the ability of California and other governments to protect their citizens and environment. Notice the difference in perspective between the language of the U.S. Supreme Court I quoted earlier and the words of a lawyer who's represented several companies in NAFTA arbitration proceedings.

In the words of that lawyer, the NAFTA expropriation provision means that "Governments that want to protect their own citizens have to pay for it." When the cost of protective regulations run in the billions of dollars, the incentive not to regulate is quite powerful.

Another issue raised by the NAFTA investment chapter has to do with democracy and public accountability. California's MTBE ban was put into place by the state's legislature and governor, all of whom are directly accountable to the public. What's more, before the Governor ordered the ban, he published the results of the University of California Scientific Study and held three extensive public hearings. In other words, the ban was a response to a public threat by people accountable to the public.

In stark contrast, Methanex's challenge to the MTBE ban, like all the NAFTA investment challenges, is being heard and decided in secret by a panel of three private arbitrators whose decisions are binding in domestic courts. The rules generally require that these investment proceedings, including documents submitted to the panel and any meetings with the parties, be kept confidential unless both the challenging corporation and the defending government agree to make the proceedings open. Such an agreement has never happened in a NAFTA proceeding.

This closed system, which some of its officials call a system of "private justice", is completely contrary to the democratic protections we employ in California and throughout the United States. Here, all but the most sensitive court proceedings are open to the public and closing them requires special justification. Individuals or organizations with an interest in the outcome of a case can often participate, either by becoming a party or as friends of the court. This means that the courts are informed of special concerns or considerations not presented by the parties and that matters of importance to the public are decided in public, not so with NAFTA.

In the *Methanex* case, I represent three environmental groups who worked with the California government to ban MTBE. We have petitioned the arbitration panel for permission to participate so the panel can consider the interests of the people of California. Although the panel decided it had the power to accept our written petitions, not that it would, just that it had the power to do so, it refused to permit us to attend the hearings or to have direct access to the documents submitted by the parties.

Moreover, when the measure at issue is a state or local law, as with California's MTBE ban, the lack of accountability becomes even greater. Under NAFTA, it is the United States, not the state or local government,

that must defend the investors' challenge. This means that not even the government that decided the measure was necessary is guaranteed a chance to defend its decision. This should be especially troublesome to Californians. We are often at the vanguard of health and environmental protection, implementing important measures before others, including the U.S. Government, recognize their value. With Chapter 11, we have to defend the defense; we have to entrust the defense of those measures to someone else.

I hope the picture I'm trying to paint is clear. NAFTA's Chapter 11 allows foreign corporations to use secret and powerful private tribunals to challenge democratically enacted measures, no matter what public interest those measures promote whenever those measures affect their investment. A state government gets little, if any, say in the defense of its actions.

In conclusion, I will say that the matter appears only to be getting worse. The federal government is presently negotiating with 34 other governments to create the Free Trade Area of the Americas, an expansion of NAFTA's rules throughout the hemisphere. The early draft of the agreement, and this goes to your question, Senator Kuehl, the early draft of the agreement includes provisions that essentially mirror those I have just described, although the U.S. Trade representative refuses to make its precise position on the investment rules or any others public. It has published very cursory summaries of its position but it refuses to disclose the precise details of proposals that it's making to these other governments.

The FTAA, the Free Trade Area of the Americas, would greatly increase the likelihood of future challenges to California health and environmental measures. So the negotiations of this agreement are another opportunity for California to show the rest of the nation the way. California and your committee should clearly express its objection to any

federal trade agreement that weakens its ability to protect its environment and the health and well-being of its citizens. It should demand that private investors not be given special powers and their own secret procedures in which to exercise them. It should insist that measures enacted democratically be reviewed democratically, and it should take these steps on behalf of Californians before it is too late.

Thank you.

SENATOR KUEHL: Thank you very much.

Senator Machado.

SENATOR MACHADO: Thank you.

It seems like what you're saying boils down to the fact, that if a foreign country participates in a marketplace, the act of participation brings about a property right that can claim, if the market is altered and they lose economically, they have a claim against it.

MR. WAGNER: That is the claim that these investors are making.

SENATOR MACHADO: We don't even have that between our own states.

MR. WAGNER: That's exactly correct. In fact, I should point out that foreign investors can bring these claims against the United States, but California internal investors don't have that right.

SENATOR MACHADO: I also find interesting is that I remember the discussions taking place initially with respect to the development adoption of NAFTA that Chapter 11 was not talked about or focused in terms of what was going to happen.

MR. WAGNER: That's exactly right, and the example that Bob Stumberg cited of the multi-lateral agreement on investment is an example of an instance in which it wasn't talked about for a long time. When people finally paid attention and realized what a concern it was, there was public outcry and in fact the effort was eventually, if not quashed, at least redirected in another direction and maybe we can do

that with respect to the Free Trade Area of the Americas if powerful voices like California are raised against.

SENATOR KUEHL: I'm not at all really conversant with international law and the law of these trade agreements.

Would the FTAA supercede NAFTA or would NAFTA continue to be the agreement among these three countries, whereas the FTAA would then bind all the other countries?

MR. WAGNER: Well, there are several options in that respect. Because we don't know the exact text, we don't know exactly what will happen.

SENATOR KUEHL: I was hoping there was an amendment or a different set of provisions about the ability of investors to bring these suits in the FTAA. Supposing 36 states said there was an outcry, and in the negotiations there was some improvement from the point of view of the states here in the FTAA and it was different from Chapter 11, would Chapter 11 remain in effect as to Canada and Mexico?

MR. WAGNER: As long as the FTAA agreement didn't say something specific about NAFTA or the three NAFTA governments didn't change it, both of them could remain in effect.

SENATOR KUEHL: Much of the way we do in state law would be really the same?

MR. WAGNER: Exactly. One important thing to say would be that all of these other countries, these 31 new parties to the agreement, would be bound by the FTAA provision, not by the NAFTA provision. So at the very least, we would be preventing an expansion of this problematic regime throughout the hemisphere.

SENATOR KUEHL: What's the status of the negotiations; do you know?

MR. WAGNER: Well, they are in process. The idea is that they be completed by 2005. There was recently a summit in Quebec City at

which the governments promised to release a draft of the agreement. They have not done so, although a draft of the investment provision was leaked and it does indeed propose provisions almost identical to NAFTA.

Now it's hard to know exactly what that draft means because it's full of bracketed text and alternative proposals. But the general gist of the investment provision is that it will look like NAFTA's, and I actually have a suit against the USTR right now because USTR, as I said, has refused to produce to the U.S. public documents that it's given to every one of the governments that it's negotiating with saying this the U.S. position, and really, it's important to know what the U.S. position is and what the words of that provision are because the devil is in the details. We need to know what the words of the provision are.

SENATOR MACHADO: Are you finding an increasing interest across the broader scope of the U.S. economy with respect to concern about Chapter 11? A lot of the context of what you're saying is coming back in terms of environmental perspectives and other social justice issues. But if you take a look, any business should be concerned about this. Is there an increasing concern being shown?

MR. WAGNER: I think businesses are aware of the issue. I think to the extent that the proponents of environmental and social justice concerns begin to raise it more, that business will begin to pay more attention.

SENATOR MACHADO: Is it your opinion, though, that the current administration is not looking with concern to the provisions of 11 now?

MR. WAGNER: I think that's correct. The current administration has made very clear that they are not interested in bringing environmental or other social justice issues into trade agreements.

SENATOR MACHADO: The context of this goes far beyond that.

MR. WAGNER: Absolutely. It does.

SENATOR MACHADO: Particularly when you look at the scope of countries that would be brought into this and the spectrum of economic activity that that would represent, I think, raises a great deal of concern, particularly on a level playing field domestically where the U.S. business, though reluctant at first, usually accept some of the significant changes that we bring about because of the overall benefit to society, MTBE being one of them. So they just didn't participate in the economy accordingly. It puts them at a disadvantage when you're subjected to the type of claims that you have mentioned.

MR. WAGNER: Right. And the momentum for provisions like this in the Free Trade Area of the Americas was created by the Clinton Administration, but there's been no indication by the Bush Administration of any change of position.

SENATOR KUEHL: We're rapidly sort of running out of time here, and I know we're both somewhat overscheduled and I'm certain that our witnesses are too.

I wanted to make certain that I followed up on this issue about subsidies which is yet another area of concern too because we had some discussion about it and there was some testimony about it.

But, Professor Stumberg, I'm not certain that we sort of laid the informational groundwork about it. Perhaps you feel that you did but I didn't think so. (Laughter) But it would be very helpful if you would, obviously, as quickly as possible, indicate to us, sort of the basis for this issue of concern in the international trade agreements about subsidies.

PROFESSOR STUMBERG: Subsidy 101 in five minutes?

SENATOR KUEHL: Yes.

PROFESSOR STUMBERG: The agreement is called the Agreement on Subsidies and Countervailing Measures. Let me just pick out three or four sections of that agreement and tell you about it.

One section prohibits, that's the word – it's not clear to me the WTO could prohibit anything except to bring economic pressure to bear on a government -- but it prohibits certain kinds of subsidies, namely, subsidies which are contentioned upon export performance. A recent WTO panel, the one in the case the United States lost, basically said that means there must be a direct relationship between subsidy and international trade but not an indirect relationship. It's a somewhat broader understanding of the word "contingent". It also prohibits subsidies which basically require the use of domestic content.

A second provision of this agreement called the so-called "yellow-light subsidies", allows governments to challenge a subsidy at any level of government – federal, state, or local – but only if it has an adverse effect on business from that country. One of the tests is called serious prejudice. For example, if a subsidy has an impact of 5 percent or more on the price of the product, it could be challenged. I would add that that's a pretty high burden of proof. I've spoken to the staff of the WTO Subsidies Committee in Geneva, and they feel that that would be a very difficult burden to manage. So it would be a major undertaking for a country to bring a yellow-light case against a subsidy in another country.

There's a third provision of the agreement which basically requires governments to disclose all subsidies, all subsidies which fit the definition of the WTO agreement, to the WTO. This provision to date has been honored in the breech. There have been very few such subsidies posted, primarily because everybody knows, that if you post your subsidies to the WTO, you're basically creating a target list for yourself and nobody wants to be on a list. But I believe Dave said in his comments that about 200 state laws have been listed.

Finally, there was a provision to protect broad categories of subsidies that state governments were particularly interested in. These were the so-called green-light subsidies and they included, in terms of

volume, most importantly, research and development subsidies. California is into this kind of subsidy big time, as are almost all states, through university partnerships and technology development and transfer of programs.

In addition to green-light categories, they included subsidies to help pay a company to meet one-time cost of compliance with environmental regulations and finally subsidies to distressed areas.

All of these general exceptions, however, have expired. They were sunsetted at the end of last year, and it would take a new round of the WTO now to put them back into place. So what kind of state subsidies might be caught up in this thing?

Remember, as I said, it would be difficult to bring a challenge against the yellow-light subsidies on the grounds that you can prove an adverse impact on subsidies from another country.

First of all, there are a few, not many, just a few California programs that probably fall in the prohibitive category because they're explicitly there to finance or offer credits or subsidized exports. That's their job. It's right there in the code. You can tell by reading it that there is an issue.

In addition to that, technically speaking, any export promotion program is a service which would be kept classified as a subsidy under the WTO agreement. These are not big-dollar programs. Every government in the world practically does this, so governments are not likely to be attacking each other because they promote their own exports. However, if a government attacks a red-light subsidy which is real, which is a significant dollar amount because it does finance or provide credits or a subsidy for exports, it would not be hard to attach all these other small promotion programs to make the case bigger. So that's one thing I would raise as a concern and it's worth studying. I'm not saying that anybody who has California's programs in the crosshairs for a trade

complaint. But it seems to me, that if you want to be a prudent legislative planner, you would look to the potential for future conflict in that category.

Now what about the yellow-light programs? I think it's worth paying attention to the big-ticket items simply because California is the sixth largest economy in the world. California does aggressively promote and subsidize export industries. Now these are not subsidies which are targeted to promote exports, but they are industries which by their nature are export industries. Consider the volume of California subsidies. I believe we counted over $7 billion of California tax or direct-cash subsidy programs.

Among the states as a whole, it's a $47 billion enterprise. That is such a huge amount of money. It's far more than the federal government subsidizes commerce or economic development. The United States has maintained to the European Union all along that we don't have anything in consequence at the state level when the European Unions darned well know better.

So when you consider the size of the state subsidy enterprise, the fact that California is the biggest target among states, then I think it is prudent to look at your largest programs, even if they're not red light, and I would offer you three examples, only because these are all subsidy categories, not single programs necessarily. But these are all categories where the United States is out there picking on some other country, and there's a chance of tit-for-tat retaliation if the United States brings these actions against other countries or there's a brewing dispute.

Those categories include wood, cultural industries, and agriculture. We all know that agriculture is *the* big issue. It's the issue that kept the Seattle round of negotiations from happening. There is a so-called peace agreement between the United States and the European Union which expires in 2003 and then, bar the door, there's no telling what might

happen in terms of actions by the United States against the European Union because of their massive agricultural subsidies.

If the European Union responds in kind and they want to sweep in some of these state programs just to turn up the heat and increase the pain, where will they look first? I would suggest perhaps California agricultural subsidies of which you have a few fairly big-ticket items.

The cultural industries issue, again, as the United States banging on the European Union because of their extensive so-called financing programs for cinema and all sorts of other regulatory limits on the content, based on language or country of origin, which really acts as a market barrier for the United States; if the United States persists and wins one of these cases against the European Union, which I think it has a good case to do, how might the European Union retaliate? Well, by looking at American federal or state subsidies that support the film industry. Again, California is not only the leader in the film industry but the leader of subsidies from the film industry.

Finally, in terms of wood, as you know, the soft-wood dispute is brewing. It's reaching the temper-tantrum stage, in terms of the arguments going back and forth between the United States and Canada. What California has is a very innovative hardwood initiative. It combines a number of subsidy packages related to wood processing and distribution and to add value to wood. I'm not saying that that is in any way a red-light program. What I'm saying is, if the Canadians want to get nasty and pick on state and local programs, California has the most visible and innovative program that they could choose to pick on.

I'm just suggesting that it's worth a closer look to see legally whether or not these programs are arguably at risk if they're packaged together, if subsidy programs are aggregated, like California claims it does, to achieve the biggest bang for the buck, to use multiple subsidies to really help your constituents be effective competitors in the global

economy. So all of that I would fit under the role of oversight. Do you know what might hit you in the next ten years? That's my list, those four kinds of subsidy programs – one red-light and three potentially yellow-light programs.

In terms of your own lawmaking again, I would promote an agenda of subsidy reform, not necessarily to comply with the WTO agreement but rather to protect California taxpayers to make sure that you get something for the subsidies you invest, to make sure that they're effective, and that the subsidies are accountable for a public purpose, such as training workers or promoting environmental compliance rather than simply helping one California business competing against another California business.

When it comes to advising U.S. Trade representatives, that third role, there's a clear agenda. There is plenty of room for you to recommend to the USTR a number of general exceptions, i.e., putting back in place a set of green-light subsidy programs, which would allow any government around the world to use subsidies but only to promote a public interest where that public interest is clearly defined, it's accountable to the taxpayers, and it's a justifiable imposition on international trade, one for which there is a tradeoff of a public benefit for whatever burden might be cause for trade.

SENATOR KUEHL: Thank you very much.

Senator Machado, any questions before we close here?

SENATOR MACHADO: No, I don't, Senator, but I wanted to thank you for the food for thought and you made sure this is not going to be the last forum.

SENATOR KUEHL: Well, let me thank all the witnesses for the clarity and completeness of the testimony. If there were second thoughts, third thoughts, or fourth thoughts that were not expressed to

the Committee, we would welcome continuing dialog with you all. Write to us.

I want to thank particularly the staff of the Select Committee, at least from my point of view, Anne Blackshaw and Jason Berkman, who worked very hard on this hearing. I'm certain Senator Machado would like to thank his staff as well.

SENATOR MACHADO: Yes. I want to thank Trudi Sprague. She's been very helpful in our International Trade and I look forward to further collaboration.

SENATOR KUEHL: Well, I think there definitely will be. We will continue a series of hearings. Senator Machado and I know that we're here through 2004 (laughter) and hope to be here through 2008.

This is an issue that we will continue to explore, continue to be aggressive about, work with NCSL, work with the environmental community and the labor community and all others who have been affected by the investor provisions and other provisions of these agreements, to work with you, Professor Stumberg, I hope, closely in terms of following some of your advice and continuing to understand what our role can be and to be pretty aggressive about it. Since we are independent, we can be just as obnoxious as we possibly can accomplish. (Laughter)

SENATOR MACHADO: That's usually not a challenge. (Laughter)

SENATOR KUEHL: At least I can be. I don't know whether Senator Machado is even capable of being obnoxious. I've never seen it.

Again, thank you very much. Thank you all who were here and we'll see you at the next hearing.

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